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MILLENNIUM CHALLENGE CORPORATION

MCC FR 17-05

Notice of Entering into a Compact with the Federal Democratic Republic of Nepal

AGENCY: Millennium Challenge Corporation.

ACTION: Notice.

SUMMARY: In accordance with Section 610(b)(2) of the Millennium Challenge Act of 2003 (22 U.S.C. 7701-7718), as amended, and the heading "Millennium Challenge Corporation" of the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2017, the Millennium Challenge Corporation (MCC) is publishing a summary of the Millennium Challenge Compact between the United States of America, acting through MCC, and the Republic of Nepal. Representatives of MCC and Nepal signed the compact on September 14, 2017. The complete text of the compact has been posted at:

<https://assets.mcc.gov/content/uploads/compact-nepal.pdf>.

Dated: September 25, 2017.

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Vice President and General Counsel
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BILLING CODE 921103

SUMMARY OF THE NEPAL COMPACT

Overview of MCC Nepal Compact

MCC's Board of Directors has approved a five-year, \$500 million compact with Nepal aimed at reducing poverty through economic growth. The compact seeks to assist Nepal in addressing two binding constraints to economic growth: (i) inadequate supply of electricity; and (ii) high cost of transportation. The compact will address these binding constraints by investing in two projects: the Electricity Transmission Project and the Road Maintenance Project.

Background and Context

Nepal's economic growth, labor productivity, and gross domestic product per capita are among the lowest in South Asia. A decade of civil and political unrest from 1996 to 2006 continues to shape the social, economic, and political landscape of the country. The people of Nepal continue to deal with the fallout from a series of devastating earthquakes in 2015 that killed nearly 9,000 people and pushed an additional million below the poverty line. Almost half a million people leave the country each year for economic opportunities elsewhere. In September 2017, Nepal will hold the final phase of a three-phase local, democratic election in hundreds of municipalities throughout the country. These local elections are the first in 20 years and the first to be held since Nepal ratified its constitution in 2015, a critical step in continuing to foster transparency and accountability in government.

The proposed compact is designed to address the underlying causes of two binding constraints to Nepal's growth: inadequate supply of electricity and high cost of transportation. Nepal suffers from the worst electricity shortages in South Asia, and new investment in Nepal's electricity sector is critical to achieve economic growth. Only half of the demand for electricity can be met by the nation's grid, which has resulted in load-shedding of up to 18 hours a day during the dry winter months when hydropower generation is low. The constraints to growth analysis found that the low availability of electricity creates significant costs for businesses that must run generators on expensive imported fuel. The availability of electricity is further reduced by Nepal's constrained ability to import power when needed and the high level of losses in transmission and distribution system.

The transportation sector has also suffered from Nepal's past political instability, inadequate investment, weak planning, and poor project execution. These factors have contributed to poor road quality, inefficient customs and border enforcement, an inefficient trucking industry, and inadequate road coverage. The Government of Nepal recognizes that investments in this sector are needed to reduce transportation costs and promote economic growth.

Compact Overview and Budget

After MCC selected Nepal as eligible for threshold program assistance in December 2011, MCC and the Government of Nepal conducted a constraints to growth analysis. When MCC's Board of Directors selected Nepal as eligible to develop a compact in December 2014, MCC and the Government of Nepal used the analysis completed for the threshold program to develop the proposed compact.

MCC and Nepal identified four binding constraints and agreed to focus the proposed compact on the two best suited for MCC's assistance: the inadequate supply of electricity and the high cost

of transportation. The proposed compact seeks to address the selected constraints by investing in two projects: the Electricity Transmission Project and the Road Maintenance Project.

Nepal is already undertaking significant investments in the generation and distribution portions of the power sector value chain. The proposed Electricity Transmission Project therefore seeks to strengthen the transmission portion of the value chain, which has been weakened by historic underinvestment and poor implementation. The Electricity Transmission Project plans to add approximately 300 kilometers to the high-voltage transmission backbone inside Nepal, complete the Nepal portion of the second cross-border transmission line with India for increased electricity trade, and provide technical assistance aimed at improving the sustainability of Nepal's power sector. The compact will also support Nepal's establishment of an independent and capable power sector regulator, which is essential for maintaining open, non-discriminatory access to a transmission network with transparent pricing and clear rules of engagement.

The Road Maintenance Project focuses on improving Nepal's road maintenance regime by providing technical assistance to key actors within the transportation sector. The Road Maintenance Project also includes an incentive-matching fund to encourage the expansion of Nepal's road maintenance budget, in addition to the periodic maintenance of up to 305 kilometers of the country's strategic road network.

The following summary describes the components of Nepal's compact. The MCC investment for the compact is \$500 million, with an additional \$130 million committed by Nepal to support the compact program.

Component	Total (Millions \$)
1. Electricity Transmission Project	398.2
1.1 Transmission Lines Activity	228.2
1.2 Substation Activity	114.0
1.3 Power Sector Technical Assistance Activity	22.4
1.4 Project Management Activity	33.6
2. Roads Maintenance Project	52.3
2.1 Technical Assistance Road Maintenance Reform	7.1
2.2 Strategic Road Maintenance Works	45.2
3. Monitoring and Evaluation	9.5
3.1 Monitoring and Evaluation Activities	9.5
4. Program Administration and Oversight	40.0
4.1 MCA-Nepal Program Administration	23.4
4.2 Fiscal Agent, Procurement Agent, Audit	16.6
Total MCC Contribution	500.0
Government of Nepal Contribution	130.0
Total Program Investment	630.0

Nepal Compact Budget

Project Summaries

The Electricity Transmission Project: The objective of this project is to spur economic activity and growth by improving the availability and reliability of electricity supply in Nepal's power grid, thus increasing per capita electricity consumption. This project includes four activities:

- **Transmission Lines Activity.** This activity will focus on the construction of an estimated 300 kilometers of high voltage transmission lines in Nepal, providing a vital missing link to the existing high voltage grid. Most of the proposed transmission lines traverse mountainous terrain, starting near the Kathmandu Valley, moving to the west and then southwest to the Indian border. The particular lines were selected following careful analyses and feasibility studies that weighed their technical and economic merit, their importance in meeting Nepal's medium and long term electricity supply goals, and their consistency with Nepal's domestic and cross border transmission investment plans. The transmission line route was selected to minimize impact on people and sensitive geographic areas, to the extent possible. Moreover, the activity includes funding for certain community benefit-sharing activities in order to further mitigate potential social

impacts from construction of the transmission lines. Potential activities include rural electrification through off-grid solutions and community empowerment programs.

- Substations Activity. This activity is complementary to the Transmission Lines Activity. The proposed compact contemplates constructing three substations. In combination with the transmission lines, these substations would help evacuate and transmit power collected from three major river basins where large hydropower projects are under construction by investors, many of which are private. The substation near Butwal would be the starting point for the transmission line to the Indian border and power grid.
- Power Sector Technical Assistance Activity. This activity seeks to strengthen the proposed power sector regulator (Electricity Regulatory Commission) to help bring transparency, efficiency, and competition to the power sector. The activity would help Nepal embed experts within the Electricity Regulatory Commission to improve the skills of this nascent agency in areas such as rule-making, dispute resolution, and economic and technical regulation. This activity would also help the Nepal Electricity Authority improve its transmission operations and prepare for oversight from the new independent electricity regulator. This will help establish a regulatory cost recovery system, improved grid operations, and better power system planning within the Nepal Electricity Authority.
- Program Management and Technical Oversight Activity. This activity is designed to complement the Transmission Lines and Substation Activities by supporting project management, environmental and social impact assessment, and engineering and technical supervision. This will allow the compact to properly implement the proposed infrastructure investments while complying with MCC's technical, environmental, and social standards.

The Road Maintenance Project: The objective of this project is to avoid future increases in transportation costs across Nepal's road network by preventing further deterioration of maintained roads and to improve the administration of road maintenance. This project has two activities:

- Technical Assistance Activity. This activity is planned to build capacity for the Department of Roads and Roads Board Nepal in (1) improved data collection; (2) preparation of appropriate road maintenance plans and cost estimates; (3) improved prioritization of periodic maintenance; (4) improved contracting and contracting management; and (5) improved project management.
- Strategic Road Maintenance Works Activity. This activity seeks to complement and build upon the Technical Assistance Activity by incentivizing additional government spending on road maintenance. The activity would establish a matching fund to provide \$2 for

every \$1 Nepal spends above its current average annual amount for road maintenance, up to a total of \$15 million annually for three years. The activity would additionally provide for the physical maintenance of an initial 305 kilometers out of the 2,000 kilometers of Nepal's strategic road network.

Economic Analysis

The proposed Electricity Transmission Project has an estimated economic rate of return of 12 percent. The investment in Nepal's transmission system is expected to affect all grid-connected consumers, which represent 72 percent of Nepali households. With a projected population in 2024 of 31.5 million people, an estimated 23 million individual beneficiaries living in five million households are expected to benefit from this project. Fifty-two percent of the potential beneficiaries are estimated to be female.

The estimated economic rate of return for the Road Maintenance Project is 29 percent. The 305 kilometers of roads proposed by Nepal for periodic maintenance under the compact are spread across five road segments in five geographic areas. The Project is expected to benefit approximately 924,000 people in 205,000 households.

MCC anticipates that there will be overlap in the beneficiaries of the two proposed projects and thus ultimately expects the compact to benefit approximately 23 million individuals.

Policy Reforms and the Compact

MCC will require certain conditions to entry into force of the compact in order to ensure sustainability of compact investments. For example, given the proposed compact's focus and the clear need for a second cross-border transmission connection with India, MCC will require that technical and financial arrangements for the construction of the complementary investment in India be finalized before entry into force of the compact. This requirement is expected to be further strengthened through conditions regarding the Nepal portion of the cross-border transmission line that must be met for certain compact disbursements.

The proposed compact includes several key reform elements, supported by technical assistance activities in each project. The Power Sector Technical Assistance Activity includes conditions to help Nepal create a transparent and efficient electricity market. MCC believes that the establishment of the Electricity Regulatory Commission as an independent and capable regulator is essential for maintaining open, non-discriminatory access to a transmission network with transparent pricing and clear rules of engagement for all power market participants, particularly investors in generation projects. The compact proposes to increase the utility's planning, operations, and cost recovery mechanisms to help ensure the sustainability of the proposed investments. Strengthening the utility's transmission operations should ensure its viability if Nepal decides to spin off or merge those operations with an independent transmission company. MCC has conditioned the entry into force of the compact on satisfactory progress toward parliamentary approval of a bill to establish the Electricity Regulatory Commission. Further, funding for the Power Sector Technical Assistance Activity will only be provided if the Electricity Regulatory Commission bill has been passed by the Nepali parliament.

For the Technical Assistance Activity in the Road Maintenance Project, MCC will provide compact funding for maintenance works only if Nepal increases its own historically low spending levels on road maintenance. The compact is expected to incentivize Nepal to increase its spending for road maintenance significantly by making MCC funding conditioned on increased Nepal spending.

[FR Doc. 2017-20847 Filed: 9/26/2017 11:15 am; Publication Date: 9/28/2017]